The Challenge to Lead

U.S. Global Economic Responsibilities in the 21st Century

by BRUCE STOKES

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Foreword

As we approach the beginning of the next century, it seems clear that the United States has the economic capacity not only to compete effectively in the new global economy, but to lead that economy in a direction that will promote freer markets, reduce conflict, and improve living standards for people worldwide. It is less clear, however, that the United States has the long-term political will needed to provide and sustain the leadership required to do this.

Since its founding nearly 60 years ago, the Committee for Economic Development has worked extensively in the areas of international trade, finance, and investment. As part of this ongoing program, we are pleased to publish *The Challenge to Lead: U.S. Global Economic Responsibilities in the 21st Century* by eminent international scholar, journalist, and CED advisor Bruce Stokes, who is a Senior Fellow at the Council on Foreign Relations and a columnist for the *National Journal.*

This comprehensive volume provides a broad overview of the current issues in international trade and finance that face the United States. While the views are those of the author and not necessarily those of CED's Board of Trustees or professional staff, we believe *The Challenge to Lead* will help CED and others think through some of the difficult policy issues facing business, government, and international institutions in the coming years. We are proud to publish this important work.

Charles E. M. Kolb
President
Committee for Economic Development

Introduction

The fate of the American economy is now closely tied to the world marketplace. Never have Americans been able to consume so much from abroad (whether the latest high-quality VCR or computer) or sold so much to foreigners (from passenger jets to mutual funds). Never before have so much economic activity in the United States and so many jobs been dependent on exports. Not in recent history have interest rates in America benefited so much from the influx of foreign capital, making cars and homes more affordable.

And rarely have American jobs and the U.S. financial system been so vulnerable to rapid changes in the global economy. What started out in 1997 as a banking collapse in Thailand eventually brought down many of the economies of East Asia and infected Russia and Latin America. The downturn, initially propelled by fundamental changes in financial markets, spread to the real economy—to shopkeepers in Japan and steel makers in the United States—and threatened the prosperity so newly won through international market integration.

By early 1999 the sense of crisis was easing. Korea and Thailand seemed to be recovering. The Brazilian economy, which had threatened to collapse, was holding together, and the Russian contagion appeared contained. But serious systemic problems remained. Japan was headed for its third year of recession. The Chinese economy appeared fragile. And Europe's economy was slowing.

These challenges past and present pose new threats to America's ability to lead in the international economic arena. This task is complicated by the fact that deep systemic changes in the global economy are now occurring that will make this work harder. The volume and complexity of international capital transactions will increasingly tax government's regulatory capacity. New markets, in and out of cyberspace, test government's ability to devise new rules of the road for trade, investment, and taxation. New actors—a European Union united with a common currency and China—and the sudden weakness of others, especially Japan and some of the newly industrial states of Asia, complicate efforts to build leadership coalitions and international consensus. American taxpayers are resisting the financial burden of leadership, and the international institutions created at the dawn of the post-war international economy have been overtaken by events and may be in need of reform.

Only the United States can rally other nations to join in the revival of the global economy, the restructuring of the international financial institutions, the definition of a new regulatory framework for the global financial system, the further liberalization of world trade, and the building of a new consensus on the future direction of the world economy.

The need for such recommitment is clear. Events since 1997 suggest that the status quo is not sustainable. The global financial crisis was a wake up call, a painful reminder that the world economy is changing and that the attitudes of government leaders, businesses, and average citizens need to change too. The United States, and the world, can no longer depend upon old policy tools, old institutional structures, and an outdated vision of the future to deal with the problems and to realize the opportunities of an increasingly global and borderless economy.

America needs to respond to these challenges with the same sense of urgency that inspired creation of the post-war system two generations ago.

The stakes are high. Before the Asian financial crisis hit, one-third of U.S. economic growth and 12 million relatively high-paying American jobs depended on exports.[1] The performance of our financial markets increasingly depends on growth in emerging markets and the international performance of U.S. firms.

The task is formidable. In response to the immediate crisis, the United States needs to mobilize international efforts to avoid a global recession by taking the initiative in alleviating the overwhelming burden of indebtedness in emerging markets. For the long term, America must lead the effort to revive flows of long-term capital for emerging markets, steer the international debate on regulating international short-term capital flows, be the primary architect of any reform of the international financial institutions, and help craft safeguards that ensure that the liberalization of capital markets does not outpace the regulatory capacity of individual nations.

Since trade and foreign investment stimulate growth, the United States needs to redouble the effort to broaden and deepen market liberalization. This will further expand trade in agriculture and services, remove regulatory barriers to commerce and direct investment, and shape the agenda for the new multilateral round of trade talks. And a way must be found to integrate China and Russia into the world trading system.

To succeed in these efforts, the United States needs the authority and resources to lead, a coherent strategy to achieve its goals, and the help of like-minded allies.

Developing a domestic and international consensus on the shape and nature of a new global economy will require vision and sustained commitment. It will also require a willingness to listen as well as preach (both to our allies and to our own people) and a judicious and restrained exercise of U.S. power.

The challenge is daunting. But the rewards are great. And the cost of failure is unacceptable.

The U.S. Stake

Two generations ago, at the dawn of the second half of the 20^{th} Century, America had a relatively self-contained, continental economy. All that really mattered economically to most Americans happened between the Atlantic breakers on the east coast and the Pacific surf on the west. The trade and investment that flowed across those oceans was of little material importance, for better or worse, to the daily lives of average Americans.

Today, on the eve of the 21^{st} Century, the United States is a global economy. The livelihoods and the economic futures of an unprecedented number of Americans, their children, and grandchildren are now wholly or in part dependent upon imports, exports, and the two-way flow of international investment. This transformation has forever changed America's stake in the world economy and boosted the premium on U.S. leadership in global economic affairs.

By Almost Every Measure

By almost every measure—trade, direct foreign investment, equity purchases, bank lending and even governmental borrowing—the globalization of the American economy has advanced with remarkable speed.

In 1975, the sale of U.S. bonds and equities to foreigners and the purchase of foreign bonds and stocks by Americans measured only 4 percent of U.S. GDP. By 1997, this measure of U.S. participation in world capital markets had risen to 213 percent of U.S. GDP.[2]

In the last 15 years, foreign direct investment in the United States grew five-fold. As a result, 5 percent of the labor force now work for firms that are wholly or partially foreign owned.[3]

During the same period, direct investment abroad by American businesses grew four-fold. Moreover, while the United States used to account for less than one-fifth of global foreign direct investment outflows, it now accounts for nearly one-third. And more and more Americans have sought higher returns on their money by increasing their foreign portfolios. While in 1975 only one percent of equities held by American investors was foreign, by 1996 that portion had grown to 10 percent.[4]

Between 1970 and 1994, U.S. imports and exports rose from 11 percent of GDP to 24 percent, a 118 percent increase. During the same period, this measure of openness rose by only 43 percent in France and 24 percent in Germany, while it actually fell by 17 percent in Japan. When the tariff cuts mandated by the Uruguay Round are fully implemented, U.S. import duties will be lower than those in Japan or Europe. The American economy is now among the most open to international competition of the major industrial nations.[5]

The Changing Nature and Benefits of Integration

These broad numbers fail to capture the changing nature of the U.S. economy in its deepening interaction with the world. While the United States continues to export impressive quantities of manufactured goods like aircraft, chemicals, and machinery, our clear competitive advantage is in services such as banking, consulting, accounting, travel, and education. The United States ran a $79 billion services surplus in 1998, and this surplus has become increasingly important. In 1987, for example, at the peak of that decade's trade imbalance, the services surplus offset only five percent of the deficit in goods. In 1998, the positive balance in services offset 32 percent of the goods deficit.[6]

The consequences for the American economy of this exposure to global competition have been revolutionary. Facing well-built, efficiently produced, and thus competitively priced Japanese-built cars in the marketplace, between 1989 and 1994 the Big Three cut the number of man-hours needed to build a car by 17 percent and design and production time for a new model by 15 percent. Similar improvements have been experienced by American firms venturing into the world marketplace. Productivity is now almost 40 percent higher on average in American plants that export a range of goods than in plants that produce only for the domestic market.[7]

Globalization has also provided individual working Americans with more jobs, better wages, and greater employment stability. Export-related employment in the United States accounted for 23 percent of new private industry job growth in the first half of the 1990s; over the last decade, jobs supported by exports rose four times faster than overall private-industry jobs. Furthermore, both production and non-production workers at exporting plants receive 14 percent higher pay and one-third more benefits than workers employed by similar firms that do not export. Finally, plants that export are less likely to go out of business, cushioning workers from the ups and downs of the domestic business cycle.[8]

Americans also benefit as consumers in the global marketplace. Low-priced shirts from the Philippines, toys from China, and other products from developing countries stretch the buying power of the paychecks of American workers by an estimated 3 percent.[9]

The Costs of Globalization

America's transition from a continental to a global economy, however, has at times been painful. In the 1980s, the workers in individual industries confronting international competition paid a heavy price. Hundreds of thousands of workers permanently lost their jobs—many of them high paying—in the auto, steel, textile, and apparel industries. Others lost their jobs because of the North American Free Trade Agreement and the Uruguay Round multilateral trade agreement. In the early 1990s, before the recent dramatic fall in unemployment, 20 percent of American manufacturing workers displaced by trade took more than a year to find a new job, and those who succeeded took, on average, a 10 percent pay cut. Workers who had health care coverage in their old job faced a one in four chance of losing that benefit in a new position.[10]

While most of these people found work again during the full-employment economy of the late 1990s, it is little wonder they have questions about the benefits of globalization. And their experience is a reminder of the serious political and social problems likely to attend further integration of the U.S. economy with that of the world.

The Premium on Leadership

The stake that American investors, both small and large, U.S. manufacturers and service providers and their workers, and American consumers have in the international economy has never been greater. Driven by the force of technological innovation and capital mobility, the globalization of the American economy is irreversible. At the same time, the price of globalization, paid for by individual workers and their industries and communities, has at times been high. For these reasons, it is essential that the United States engage in the management and direction of the global economy in order to maximize the benefits and minimize the costs of further internationalization of the U.S. economy.

Reforming Global Finance

The global financial crisis that engulfed the world in the late 1990s demonstrated the interdependence of the international economic system. Not since the 1930s has the world faced such a pervasive threat of financial implosion, business stagnation, and worldwide deflation. The crisis challenged the nature and the structure of world capital markets in the 21st century. Although the crisis is far from over, some of its lessons are already clear. Global financial stability is a public good worth defending. Markets alone cannot be relied upon to solve the problems that arise in a timely and politically acceptable fashion. The United States is the only country capable of mobilizing others in a concerted effort to deal with the immediate crisis and to manage the adaptation of the international financial system in preparation for the future.

The financial turbulence that began in Thailand turned out to be a bit more serious than President Bill Clinton’s initial characterization as “small glitches in the road.” Most economists expected the Asian tumult to follow the pattern of the 1995 Mexican peso crisis, with a sharp downturn followed by an equally sharp recovery. In fact, the downturn was even deeper and far more prolonged. By the autumn of 1998, East Asian stock markets had fallen 30-60 percent, and currencies had weakened by 30-70 percent from early 1997. In 1998, the Indonesian economy shrank by 15 percent, the Thai economy by 8 percent and the Korean economy by 7 percent. By early 1999, stock markets and currencies in the affected countries had recovered somewhat and Korea and Thailand were growing again. But the Indonesian economy was still shrinking, and economic activity in the region as a whole was still sluggish. As of May 1999, the IMF is forecasting for the year 2000, economic growth of 4.6 percent in Korea, 3 percent in Thailand, and 2.5 percent in Indonesia — far below the growth rates of the early 1990s, but recovery nontheless.[11]

As if 1997 was not bad enough, the Asian flu spread to Russia in mid-1998, as foreign investors fled emerging markets. This capital flight, in combination with chronic Russian economic mismanagement and a crippling falloff in oil revenues, led Moscow to default on its domestic debt. This event spooked investors all over the world, triggering a flight both to quality investments, such as U.S. Treasury securities, and into short-term investments. Global stock markets lost more than $2 trillion in value.

The gyrations of the market hit leveraged investors, including both hedge funds and banks, particularly hard. They found themselves overextended in losing positions and were forced to sell their assets into very thin markets at distressed prices. The near bankruptcy of one of the world’s largest hedge funds, Long Term Capital Management, was only the first in a number of threatened failures, further intensifying this risk aversion.

This global financial turmoil had devastating effects on economic prospects. In October 1997, the International Monetary Fund (IMF) had forecast global growth of 4.3 percent for 1998, whereas actual growth was only 2.5 percent. By April 1999, the IMF was estimating only 2.3 percent expansion for 1999, the slowest growth since 1991.

The causes of the global economic crisis were manifold. In the early 1990s the world was awash in capital, with too much money chasing too few good investment opportunities. Thanks to low inflation, the cutback in the government deficit, and the growth of institutionalized savings through retirement systems, a huge pool of investment capital had become available in the United States. At the same time, a reduction in government spending in Japan, coupled with a dramatic rise in personal savings, created an even larger fund of available Japanese capital. New financial tools—derivatives, hedge funds, sophisticated computer techniques—allowed that capital to be leveraged as never before. High rates of return in emerging markets and near zero rates of return in Japan helped trigger an unprecedented shift in global resources into the economies of Thailand, Korea, Indonesia, and Brazil. The doors were open to such investments thanks to pressure from the United States and others to liberalize financial services markets in these emerging markets. In less than a decade, annual capital flows to developing countries increased six-fold, from about $50 billion to more than $300 billion a year.[12]

But with easy access to such financial capital, Asia’s private sector rapidly became over-leveraged, allocating capital carelessly, for example, to speculative real estate ventures in Thailand or to unneeded industrial capacity in Korea. In Russia, crony capitalism and rampant corruption exacerbated bad investment decisions. On top of this, a lack of transparency in corporate and national accounting and the absence of adequate financial supervision almost everywhere made it almost impossible to know how bad things really were.

But recent problems are not just the product of greed and mismanagement. They are also the unintended consequences of major changes in the nature of modern financial capitalism.

In the 1930s, Willie Sutton said he robbed banks because “that’s where the money is.” In the 1990s, the money was to be found in the capital markets. The U.S. mutual fund industry now has greater assets than the banking system. Worldwide, by the end of 1997, there were $1.5 trillion in international holdings of bank deposits and $3.5 trillion in international holdings of debt securities, as borrowers seeking capital turned to the capital markets rather than to banks.

This securitization of debt offered immense opportunities for rapidly raising massive amounts of low-cost capital. But it also increased financial instability. In an environment with virtually no controls on international capital flows, money that is easier to obtain is also easier to lose. One month foreign investors can buoy the stock price of a Korean steel maker, fueling extravagant expansion plans, only to pull the plug on the stock and the company’s future a month later when investors lose their courage or find a better opportunity half-way around the world. And capital that doesn’t flee at that moment can be destroyed over night when the firm’s stock plummets. The fact that this capital has often been leveraged to unprecedented degrees only amplifies the problem when investments have to be unwound.

The magnitude of the crisis that began in 1997 and the long-run complexity of the problems posed by the recent changes in market economies are challenges the global economy has not faced since the 1930s. At that time, the world was slow to understand the problem. Few understood the broader economic transformation that was taking place, and no nation wanted to bear the burden of both resolving the immediate crisis and adapting the global system to the new economic circumstances. Today, the world faces a similar demand for understanding, adaptation, and leadership. Only the United States has the capacity to lead an effective response.

Restructuring Debt

In the short run, economic growth in Europe, Japan, and the United States is a necessary precursor for resolving the global financial crisis. But it is not sufficient. Somehow the crushing burden of emerging market financial obligations must be restructured, as President Clinton first proposed in his September 1998 speech to the Council on Foreign Relations.

This will require burden sharing by creditors through debt-for-equity swaps, lower interest rates, a stretching out of repayment schedules, and even debt forgiveness. The large number of private sector debtors and creditors will make this much more difficult than the workout of Latin American debt in the 1980s, when the debtors were a dozen national governments and the principal creditors a relatively small number of international banks. The problems encountered in obtaining agreement among Korea's creditors in December 1997 are a foretaste of the difficulties that can be anticipated in getting diverse creditors to agree on a general restructuring plan. Furthermore, most of the Latin American debt was owed to U.S. commercial banks, giving the U.S. government great leverage in persuading those institutions to write down their loans. Today, only 10 percent of Asian debt is owed to U.S. banks, while half is owed to European banks and two-fifths to Japanese banks.

German and French banks, already under pressure thanks to domestic competition in the financial sector generated by monetary union, have expressed no interest in debt restructuring. And bankrupt Japanese banks have little room for maneuver. If the growth-sapping weight of emerging market debt is to be alleviated, the United States may have to find ways to leverage European and Japanese participation. The first step may be to ensure that the G-7 group of industrial nations commits itself to significant debt restructuring. After the Latin American experience in the 1980s and the Asian experience in the 1990s, the G-7 nations may need to accept that periodic debt restructurings are inevitable—not unlike bankruptcy in domestic economies—and develop a formal procedure for triggering debt restructuring when conditions warrant. At the very least, the G-7 may want to insist that new emerging market bond contracts do away with consensus decision making by creditors, so that decisions on restructuring debt payments could be determined by the majority of creditors.

But alleviating debt is only a palliative for the immediate problem. The crisis has underscored the need to adapt the global financial system to the changing nature of the world economy. As the principal architect of the current system, its greatest beneficiary, its leading funder, and its *de facto* leader, only the United States can lead this reform.

Managing Capital Controls

Extreme volatility of capital flows distinguished the 1997-1998 crisis. In 1997, billions of dollars fled the Indonesian economy, destabilizing the currency.

In the fall of 1998, Brazil's foreign reserves shrank at the rate of several hundred million dollars a day. And in early October 1998, so much capital moved into Japan, as hedge funds unwound their positions, that the value of the yen jumped by 20 percent in a matter of days.

Capital shifts of this magnitude are more than financial market corrections; they can have a disastrous impact on the real economy. For this reason, at the IMF's 1998 annual meeting there was a general consensus, not necessarily shared by the U.S. government, that some form of capital controls was inevitable in some circumstances.

Chile has long had restrictions on the inward flow of investment and its controls are thought to have shielded it from much of the 1997-1998 Asian economic flu. In 1998, Malaysia imposed controls on taking investment out of the country, to insulate itself from the activities of hedge funds and other speculation. And China's capital controls helped it to successfully avoid much of the turmoil associated with the Asian crisis.

But capital controls are no panacea. They tend to distort the allocation of capital and reduce the efficiency of investment. Furthermore, with unrecorded capital flows from emerging markets totaling nearly $64 billion in 1997, government curbs are likely to be ineffective. And closing the barn door after the horse has fled only ensures that the horse may not return. When investors can put their money in markets with unfettered capital mobility, they are unlikely to choose a nation that limits that flexibility. Moreover, even Chile's widely heralded controls had their drawbacks. The curbs effectively limited short-term Chilean bank exposure in dollar-denominated assets, but they crippled the Chilean equity market, hurting small and medium-sized Chilean companies that could not go abroad to raise capital.[13]

Because it has so much to lose if the world gets capital controls wrong, the United States must be at the center of any effort to manage capital flows in the future. As the world's largest debtor, required to import capital to service its international obligations, the United States would pay a stiff price if such borrowing were inhibited. With an aging population, America's pension funds will need the higher returns they can get over the long term in emerging markets and the freedom to allocate those investments to maximize returns. And as the world's largest exporter of goods and services, the United States must be mindful of the experience of the 1960s and 1970s, when capital controls and limits on trade went hand-in-hand.

Strengthening Financial Systems

Rather than play defense in the spreading international debate over capital controls, the United States should be proactive. We should change the discussion from a fight over re-imposing capital controls on countries that now enjoy free capital movement to an effort to deal with the shortcomings of the international financial system.

The activities of Long Term Capital Management and other speculative investors have greatly weakened the moral position of the U.S. government in challenging the movement toward capital controls. But Washington does have some capacity to steer the debate to the more useful ground of limits on bank exposure to highly-leveraged financial activities. Controls on hedge funds themselves would be useless; they would simply move their activities offshore. But international limits on banks' ability to imprudently lend money to hedge funds without setting aside adequate reserves may be effective in avoiding a repeat of massive, hedge fund-driven capital flows.

The banking systems of many emerging markets, and even some industrial nations, are inefficient, corrupt, and inadequate for competition in the multi-trillion dollar global capital market. If it was the weakness of the banks in Thailand and Japan that helped precipitate the current crisis, the enormous debt and backwardness of the Chinese banking system could precipitate the next one.

This problem is not new. Since 1980, three-quarters of the member countries of the IMF have experienced at least one significant banking sector problem. Resolving those problems cost more than a quarter of a trillion dollars and untold billions in lost economic growth, and such banking crises are now occurring with increasing frequency.[14]

To avoid similar problems in the future, the United States should press for a minimum set of international banking standards that would include:

- timely publication of accurate information that conforms to international accounting standards and has been confirmed by independent auditors,
- common loan classification and provisioning practices,
- tougher reserve requirements and prudential lending controls,
- disclosure of government ownership and lending to parties with close connections to the bank and its officers.

Such new standards should not apply only to the financial sector. There is a need for parallel reforms of corporate governance by borrowers such as independent boards of directors, the use of internationally recognized accounting practices, and more uniform bankruptcy standards. Shared norms for corporate governance would limit reckless borrowing and force corporations to be more accountable to their shareholders and creditors. And they would force companies to make decisions based on profitability and return on investment, avoiding many of the recent problems created by borrowing that only created production overcapacity.

Overcoming the Liquidity Crunch

Our most recent global troubles have reflected, in part, a shortage of liquidity. Just as too much money led to the excesses that caused the crisis, too little money will make it difficult for beleaguered nations to recover. Net capital flows to developing countries will fall from $311 billion in 1996 to $185 billion in 1999, according to the Institute of International Finance. In part, this decline reflects a collapse of bank lending, which will fall from a peak of $113.3 billion to an estimated $11.9 billion during this period. Without sufficient capital, it will be difficult for emerging market nations to raise domestic demand to revive economic growth.[15] Currently, in mid-1999, capital is beginning to trickle back to emerging markets. However, the last thing the world needs is a return to unrestrained bank lending and reckless investment. To avoid a recurrence of those problems, the first step toward sustainable private capital flows must be greater transparency in financial transactions that will enable investors and lenders to discriminate between good and bad risks. Governments also should clearly define the limitations of their role in future bailouts, so that private lenders are fully aware of the risks they take.

More broadly, just as national economies have a lender of last resort, the global economy needs a financial backstop. But the price is steep. As of September 1998 just three crisis countries—Korea, Indonesia, and Thailand—had borrowed $118 billion from the international financial institutions, Europe, Japan, and the United States to shore up their economies. More resources are therefore needed. Congress' long overdue approval of an $18 billion U.S. contribution to a general IMF capital increase in October 1998 triggered contributions from other nations, alleviating the IMF's immediate capital constraints. But much of that money is not usable. Some must be kept in reserve to meet potential demands by member countries that have first call on their contributions. Some is denominated in developing country currencies that would not prove helpful in a crisis. The remaining available funds could rapidly be exhausted if new problems arise in Latin America or if new speculative attacks hit Indonesia, Korea, and Thailand.

In 1997, IMF managing director Michel Camdessus said the Fund would need $160 billion in additional money over and above the $90 billion in the current replenishment. That estimate now seems on the low side, as proposals to use IMF funds in new and different ways continue to proliferate. At its October 1998 meeting, the IMF Interim Committee endorsed “lending into arrears”—making new loans to countries that have not kept up their payments on past debts. (This change was necessary to allow more lending to Russia.) President Clinton raised the price tag even further with his open-ended proposal for a new international lending facility that vulnerable emerging market economies that followed appropriate policies could tap before they get in trouble. Brazil was the first test case of this approach, at an initial cost of $30 billion. In addition, the World Bank, which has lent billions of dollars to provide a social safety net for the newly poor in Korea, Indonesia, and Thailand, may need additional funds to fulfill those obligations, at a price tag estimated to be about $20 billion.

The difficulty in obtaining Congressional approval for the most recent IMF funding and the daunting prospect of asking industrial country taxpayers during a period of slowing economic growth to further increase their contributions to the international financial institutions suggest that some other method of increasing multilateral lending capacity must be found.

The IMF could follow the highly successful example of the World Bank and borrow in commercial bond markets. But member governments might object that such a move would make the IMF less politically accountable to leading member nations. The IMF could tap Europe, Japan, or China for more funds, but the United States might object to losing influence if it no longer was the largest funder. Years ago Nobel Prize-winning economist James Tobin proposed a small tax on international capital flows. This would generate billions of dollars in revenue that could be kept in reserve for future bailouts. Or the private sector could be tapped for new money, with IMF guarantees that it will be paid back. But the price of that course might be the loss of leverage to reform misguided government policies in emerging markets.

Whatever the source, a modern global economy needs deep pockets backing it up—if not for this crisis, then for the next one.

Institutionalizing Reform

The problems in Asia, Latin America, and Russia have also highlighted the shortcomings of the international financial institutions themselves. The Bretton

Woods institutions—the IMF and the World Bank—are more than a half century old. They were built to operate in a world of fixed exchange rates and capital controls. Faced with the current crisis, their bureaucratic rigidities, staff inadequacies, and the frequently inflexible orthodoxy of their policy prescriptions have been criticized for often making bad situations worse. Nevertheless, the crisis also demonstrated that no other institutions are capable of playing their role; if the international financial institutions did not exist, they would have to be invented.

The failings of the Bank and Fund have led some critics, such as former U.S. Secretary of State George Shultz, to advocate the abolition of the IMF. Others have called for radical surgery on the Bretton Woods institutions, including a partial merger of the IMF and the World Bank, joint decision making on some issues, and a general realignment of functions.

The United States initially urged delaying such architectural reform, arguing that it would be counterproductive to spend time restructuring the fire department while it is busy putting out fires. Nevertheless, the IMF replenishment approved by Congress demanded more stringent IMF lending practices, and the G-7 is exploring reforms. But the easing of the global financial crisis by mid-1999 threatens to ease the pressure for reform. That would be a dangerous outcome, because problems inherent in the international financial institutions that were surfaced by the crisis would then remain unresolved.

The lines of responsibility between the IMF (created to help countries deal with balance of payments crises) —and the World Bank (set up to fund development) have blurred. The Bank has inexorably been drawn into crisis management, and the Fund into dealing with structural issues. A sorting out of responsibilities is long overdue.

There is also a general consensus that countries working with the Bank and Fund must be willing to publish timely economic data, that the institutions must be willing to share their country advice with the markets, and that decision making within the institutions must be open to public scrutiny. Some of this has already begun, but more transparency is needed.

Moreover, there should be closer coordination of activities among all of the other major multilateral institutions responsible for the global economy. For example, the World Trade Organization was not at the table when the initial adjustment programs were negotiated with Thailand, Korea, and Indonesia. Yet further liberalization of trade and investment is a key component of sustainable economic recovery.

Managing Imbalances

Throughout the 1980s and 1990s, the world was plagued with vast current account imbalances. In the 1980s, the United States ran up a record current account deficit with the world, both in nominal terms and in relation to GDP, saw that deficit shrink, and then watched it run up to another record in the late 1990s. Conversely, Japan ran a record surplus, saw it ebb, and then again explode.

In and of themselves, there is nothing necessarily wrong with such imbalances. As the richest economies in the world, the United States can certainly afford to service its current account deficit and Japan to recycle its surplus. But the imbalances suggest deeper structural problems, create economic vulnerabilities, and pose recurrent political problems.

International imbalances simply reflect the difference between the amount a country saves and the amount it invests. The U.S. deficit underscores the fact that Americans save too little—at less than half the German rate and less than a quarter the Japanese. Such profligacy is unlikely to be sustainable in perpetuity. At some point the world may find better uses for its cash than to lend it to the United States. Japan, for example, will eventually have to stop exporting its surplus and call it home to take care of its rapidly aging population. Moreover, the need to service its mounting international debt makes the American economy increasingly vulnerable to even minor changes in international capital flows, as Washington's policy flexibility is constrained by the anticipated reaction of international capital markets to American policies. Finally, persistent deficits can adversely affect key industries and their workers, thereby reinforcing the impression of unfairness that undermines public support for an open economy and fanning protectionist sentiments.

In managing the current imbalances, the United States faces a particular problem. In the short run, if the nations of Asia are to grow their way out of their current recessions, they must jump-start their economies through exports. If they are to succeed, the United States will need to run large trade deficits with them for some time. But experience in the 1980s suggests that when the U.S. merchandise trade deficit rises to 3-4 percent of GDP, protectionist pressures can explode. In 1999 the merchandise imbalance is likely to reach that range, at about $300 billion. Such a prospect lends even greater urgency to market-based reforms in emerging market economies to ensure that they make a rapid transition to domestic-led growth.

In the medium term, to curb its trade imbalance, the United States must give new priority to increase its saving. The first step in that direction, reaching a federal budget surplus, has been accomplished. If that surplus is now saved, it can mitigate the trade imbalance. If it is spent or dissipated in tax cuts, the trade deficit will grow even larger. Personal saving is now at a record low, and unless the government is to save for the whole society, personal saving must also increase. Unfortunately, efforts to get most individuals to save more have largely been unsuccessful, so that saving the budget surplus is especially important.

Economic Policy Coordination

Issues such as macroeconomic imbalances—where domestic economic behavior has significant international implications—coupled with increasing globalization, will inevitably reopen the long-standing debate over economic policy coordination among nations. In recent years, the United States has argued that coordination is ultimately fruitless, destined to be overwhelmed by increasingly powerful global market forces, while the German, French, and Japanese governments have held that the recent international financial crisis underscores the need for cooperation.

In the 1970s and 1980s, coordination was attempted with some success—most notably the 1985 Plaza Accord between Japan and the United States, which corrected the over-valued dollar, and Europe's Maastricht initiative, which lowered inflation and government debt in a joint effort among the 11 nations that now compose Euroland. And the absence of coordination was associated with some notable failures—the emergence and collapse of the bubble economy in Japan, the prolonged Japanese recession, and the ensuing Asian financial crisis. Yet the volume of international capecoe haun, and th ecestaluew ps myme s.

need for international cooperation will increase. Fixed exchange rates provide one option, but only at the cost of relinquishing independence in monetary policy. While there is a general consensus among economists that the benefits of flexible exchange rates (or the futility of defending fixed rates) make flexibility appropriate for many small economies, all nations face the inescapable problem that fixed exchange rates, capital mobility, and an independent monetary policy are incompatible.

This conundrum has been evident in Europe, where fiscal policy has been straitjacketed to reduce budget deficits as required by Maastricht and is likely to remain so to assist stability of the Euro. This grants a primacy to monetary policy that invests enormous power in the newly created European Central Bank (ECB). But the ECB is an incomplete institution. It has no authority to manage the Euro exchange rate and must rely on the various national central banks in Europe to intervene on its behalf. As head of the world's largest currency bloc, it is in America's self interest to press the Europeans to establish clear lines of responsibility and authority for managing the second most important currency in the world. More broadly, Washington must lead an international effort to think through how to balance future domestic and international economic goals when most nations will have flexible exchange rates and severe constraints on their economic policy tools.

Liberalizing Global Markets

In the second half of the 20th century there has been a worldwide trend toward the adoption of outwardly-oriented economic policies. The United States has long led this effort and it will need to carry that momentum forward into the 21st century.

Washington was the driving force behind the launching of the Kennedy, Tokyo, and Uruguay Rounds of multilateral trade negotiations. The benefits of this opening have been impressive. International trade has grown 16-fold since 1950, far outstripping the growth of the global economy, and the Uruguay Round agreement is expected to raise worldwide trade by another 25 percent by 2005. Expanding global commerce in this manner has helped avoid the "beggar thy neighbor" policies of the 1930s, which provided dry tinder for war. And economic growth through trade provided the fertile ground for new democracies to take root during the Cold War and to prosper thereafter.

In the wake of a global financial crisis, with many emerging market economies in deep depression, with unemployment at recent record levels in many nations, and with the advocates of globalization on the defensive and its critics emboldened, it hardly seems the time for bold new initiatives to further reduce international barriers to trade and investment. But one lesson of the Great Depression is clear: turning inward in the face of adversity only worsens the problem. The recent global crisis is partly the result of flawed liberalization, moving too rapidly to liberalize short-term capital flows without adequate safeguards such as banking supervision and transparency in financial dealings. The problems of the last few years do not show that market liberalization is, in itself, bad for developing economies. Indeed, the recovery of the Korean and Thai economies in 1999, thanks in part to a further opening of their capital markets and more transparent accounting and banking practices, suggests rather that liberalization, in appropriate circumstances, can be part of the solution. But to avoid a repeat of the 1997 meltdown, liberalization must proceed at a more measured pace with adequate safeguards. Further liberalization will require U.S. initiative at the multilateral and regional levels and a willingness to attack trade and investment barriers entrenched at the border and embedded in domestic regulation.

New Opportunities

The United States has run trade deficits for two decades. Despite the protectionist pressure engendered by those deficits, successive Administrations have generally resisted demands to close the U.S. market by limiting imports. With every indication that the trade deficit will remain high for the foreseeable future, American trade negotiators will have to redouble their efforts to open markets abroad. Since the United States is already the most open major economy in the world, it stands to realize the largest increases in export markets from further multilateral liberalization.

In the first instance, there are extensive opportunities to reduce remaining peak tariffs and quotas. However, eliminating barriers at the border was the market liberalization struggle of the past; regulatory barriers and anti-competitive market practices imbedded in the domestic economy pose the challenges of the future.

The world economy is hobbled by government regulations that inhibit competition and drive up costs, often with questionable rationales. For example, the need to repeat duplicative European test and certification procedures reduces American information technology exports by an estimated $1 billion a year, and in the past, Chinese health standards for imported fruits and vegetables cost American growers an estimated $700 million a year in lost sales. Such regulations are increasingly at the center of trade disputes.

A model of a U.S.-inspired effort at market liberalization through deregulation is the Transatlantic Business Dialogue (TABD), in which European and American CEOs identify common regulatory impediments to trade and work together to get their respective governments to eliminate them. However, only six mutual recognition agreements (MRAs) were reached in the first three years of negotiation, a testimony to the difficulty of this task. It is incumbent on Washington, as the TABD's godfather, to work to make it effective, both for the sake of the transatlantic marketplace and because the TABD is a laboratory for addressing trade and investment barriers and regulatory practices. If left unaddressed, they are likely to plague the deeper integration of the U.S. economy with Japan and other trading partners in the future.

Regional regulatory harmonization leads naturally into a global U.S. effort in the pro-competitive deregulation of markets around the world. For more than two decades, the United States has been the world's pioneer in deregulation. In that effort, Washington has gained the stature and the experience necessary to take the next step. During the recent global telecommunications negotiations, for example, it became clear that deregulating national telephone monopolies absent other reforms only creates private monopolies. So Washington successfully pushed for mechanisms such as minimum market access for foreign providers to ensure that deregulated markets were also competitive. In future negotiations over deregulation, the United States can act as the world's conscience, helping it stay focused on the goal of competitive markets rather than the mechanics of deregulation, so that both the spirit and the letter of reform are realized.

With tariffs and quotas now less an impediment to competition, the anticompetitive practices of individual firms, often long tolerated by their governments, pose a larger problem. *De jure* access to a market is useless if, *de facto,* foreign companies cannot invest or sell their goods and services because interlocking business relationships effectively exclude them.

Competition policy issues were at the heart of the Kodak-Fuji case before the WTO and the European challenge to the Boeing-McDonnell Douglas merger. The United States lacks adequate jurisdiction to pursue unilaterally competitioninhibiting cartels abroad that impede U.S. exports and investment and would pay a huge diplomatic price if it tried. But the WTO currently lacks authority over competition policy issues. As with the issues of intellectual property rights and services—both trade concerns that the United States succeeded in putting on the international agenda in the 1980s—it will be up to Washington to propose an international blueprint for dealing with anti-competitive behavior.

Finally, the rich new marketplace emerging in cyberspace—estimated to be worth $20 billion in 1998—is currently little more than a lawless frontier, lacking both rules and accepted business practices to deal with issues of access, privacy, and taxation. Fundamental questions remain to be resolved. Should the rules of electronic commerce be set by market practices or by government regulation? Is government standard setting necessary to allay the high level of consumer distrust of doing business over the Net? As the undisputed world leader in electronic commerce, the United States is in a unique position to shape this emerging business environment.

Engaging China

Nowhere is the opportunity for further market liberalization greater than in China. In the last two decades, China has emerged as a major player in the international economy. In 1989, China was the tenth largest trading partner of the United States in terms of total trade. By 1998, China had become its fourth largest trading partner after Canada, Japan, and Mexico. But this growth in overall trade masks a disturbing bilateral imbalance. Although China has generally run relatively balanced trade with the world as a whole, in 1998 the United States experienced a $57 billion trade deficit with China. While Chinese exports to the United States have grown ten fold since the mid-1980s, Chinese imports of U.S. products have increased only three fold, thanks in part to high Chinese tariffs, import licenses and quotas, and limits on foreign investment. U.S.-Chinese trade is never likely to be perfectly in balance, nor need it be. But the very large and growing disparity is exacerbated by artificial barriers that create major political problems, and they can be dismantled.

Reducing these barriers by incorporating China into the community of trading nations through membership in the World Trade Organization has been one of the most important trade policy challenges facing the United States in the late 1990s. After 13 years of on-again, off-again deliberations, Washington and Beijing have come tantalizingly close to a deal. China has agreed to open its market to U.S. agricultural products, to allow an expansion of foreign insurance company activity, to cut tariffs, to allow greater foreign investment in the telecommunications sector, and to expose state-owned enterprises to WTO rules. But as of May 1999, the accession agreement remained elusive. Washington still wanted greater controls over import surges from China and faced congressional opposition—thanks to allegations of Chinese spying in the United States and China's human rights record—to any trade deal with China.

The costs of delay will be high. Already, U.S. computer makers are missing out on millions of dollars in business because China is not part of the international Information Technology Agreement. When U.S. exporters or investors have problems in China or U.S. industry faces import surges from China, the United States cannot appeal to the WTO's dispute settlement panel because China is not a WTO member. And U.S. interests in further revival of other Asian economies are stymied because they continue to be denied full access to the Chinese market, the second largest and fastest growing in Asia.

If WTO membership for China remains on hold, the United States needs to lead an international effort in conjunction with Europe and Japan to devise an interim strategy for dealing with China in the world system. This could include joint pressure to resolve particularly egregious trade and investment problems in China, establishment of a separate dispute resolution panel to minimize trade confrontations and technical assistance to help prepare China for eventual WTO membership.

At the same time, Washington must help prepare the WTO for Chinese, and eventually Russian, membership. The world trade body is not currently set up to deal with the problems that major economies in transition to market-based systems have in meeting the requirements for WTO membership. The WTO may need a special category of transitional membership with long lead times to enable the Russians, for example, to slowly adapt their internal economies to global norms before submitting to the full range of multilateral disciplines.

Negotiating Challenges

To reap these rewards and to shape the future global marketplace, the United States must remain fully engaged in a range of multilateral and regional trade expanding activities.

America and its trading partners are committed to begin farm trade negotiations in 1999, picking up where the Uruguay Round left off. As the world's largest agricultural exporter, it is in the U.S. interest that export subsidies, credits, and credit guarantees be reduced, that remaining high levels of protection for individual commodities be eliminated, and that there be a greater international consensus on the appropriate and inappropriate use of health regulations.

In the year 2000, there will be a similar new negotiation involving service trade issues. The foremost challenge will be to broaden existing commitments, especially in the area of financial and telecommunications services. But it is now time for greater liberalization of other services in which Americans enjoy a competitive advantage, such as consulting and architecture.

These agricultural and service trade negotiations are two components of the new round of multilateral trade negotiations to be launched in Seattle in November 1999. To date, the United States disagrees with Europe and Japan over the scope and nature of these negotiations; Washington has advocated a narrow negotiating agenda, Brussels and Tokyo a comprehensive one.

Certain key issues of both substance and process for the new round are self-evident. There must be meaningful progress on the unfinished business of farm trade and services. Further delay in market liberalization in these two sectors will be costly because, as history has demonstrated, these two constituencies have the political power to halt progress on trade liberalization generally if their concerns are not addressed. Future talks should focus on a small number of other key economic sectors where further market liberalization would generate sufficient benefits to garner support both from key countries and powerful political interests. Experience suggests that the greatest opportunities involve emerging industries, not entrenched ones. If the agenda turns out to be narrow, some way must be found to blunt obstructionist behavior by countries that have little to gain from limited agreements. Similarly, if a comprehensive multilateral negotiation is pursued, some way must be found to structure such talks so that they deliver an early harvest and do not drag on for a decade.

Whatever the nature of the negotiation, the Clinton Administration must first build a consensus on U.S. goals among Congress, the business community, organized labor, and others with a stake in trade. Failure to achieve such a consensus could result in public opposition to any eventual agreement.

Consensus is needed abroad as well as at home. Many nations in the developing world see few benefits to be gained from further trade liberalization. They are still having trouble adapting their domestic economies to the reforms agreed to in the Uruguay Round. If the next round of talks is to have any chance of success, it will take the concerted efforts of Washington, Brussels, and Tokyo to allay developing country concerns about the pace and direction of market opening.

But trade is not the only international economic issue requiring U.S. leadership. Investment now drives trade, and a large portion of U.S. exports is generated by intra-firm trade. However, in the burgeoning service sector, where the ability to set up shop in a foreign country is a necessity for doing business, restraints on investment are a major barrier to commerce.

For a number of years, members of the Organization for Economic Cooperation and Development (OECD), comprising the world's largest industrial nations, attempted to negotiate a multilateral agreement on investment—rules of the road for foreign investors and the governments that host them. These talks have broken down, jeopardizing the recent rapid growth in foreign investment around the world. As a nation that benefits domestically from foreign capital and know-how and that derives significant earnings and important market access abroad through investment, America can ill afford a lack of international consensus on this crucial issue.

At the regional level, the United States can play a critical role in the broadening and deepening of the Asia-Pacific Economic Cooperation (APEC) forum and in realizing the Free Trade Agreement in the Americas initiative (FTAA). The APEC nations have committed themselves to free trade in the region by 2010 for the advanced industrial nations and 2020 for all other countries, and the nations of the Western Hemisphere have set a similar goal of free trade in the region by 2015. With the nations involved already wavering, however, the United States will be needed to provide the impetus for them to live up to their commitments or to set more realistic objectives.

Finally, only the United States can lead the global trading system in reconciling concerns about labor and environmental issues with trade liberalization. American non-governmental organizations have most forcefully and articulately raised these concerns, but without the concurrence of the American business community—the world's largest and most extensive—such reconciliation will be impossible.

Since there is no internal consensus on labor and environmental issues in the United States, it will be difficult to build an international consensus. But some principals may guide the effort. The North American Free Trade Agreement (NAFTA) requires that Canada, Mexico, and the United States enforce their own laws with regard to labor and the environment. This is not an unreasonable starting point for dealing with labor and environmental concerns, especially since the international community stresses the importance of the rule of law in creating an open commercial environment. Moreover, if trade liberalization is to retain public support, there is a need for demonstrable progress in improving incomes and working and environmental conditions in the wake of trade agreements.

A New Model for Leadership

U.S. global economic leadership faces a unique challenge. As the world's premier economic power, the United States alone has the resources and the global reach to exercise leadership that is systemic and responsive to the needs of the world economy as a whole. Yet to ensure that the American people will support that leadership, America policy makers can never lose sight of U.S. self-interest and its requirements. Without the authority and the resources to lead, the vision to put these tools to work, and the cooperation of like-minded nations, the United States could rapidly find itself a Don Quixote tilting at windmills.

Authority and Resources

Congressional failure to pass "fast track" trade negotiating authority has thrown U.S. trade diplomacy on the defensive. The United States can and will proceed with trade negotiations even without fast track. But without such authority, our ability to deliver on our commitments will be suspect. Moreover, when the President lacks negotiating authority, countries that are already reluctant to open their markets have a ready-made excuse to drag their feet in negotiations. The United States needs the authority to strike trade deals and keep them; whether that authority is broad or narrow is less important.

A broader issue concerns the costs of maintaining the international system. The days when the United States bore all the costs are long gone. Now the danger is the reverse—that the United States will not carry its weight in the IMF, the World Bank, and the regional development banks.

Congressional approval of the U.S. contribution to the IMF in the fall of 1998 was an important commitment of resources to back up America's international economic self-interest. But the long delay in passing this appropriation was not reassuring, and the continued U.S. failure to pay its United Nations' arrears is a stark reminder of America's reluctance to put its money where its interests lie. Americans eventually must reconcile their interests with their willingness to pay to protect them. The price of committing fewer and fewer resources to the management of the global economy could be a loss of the effective American veto in the IMF and the World Bank and a significant reduction of our influence in other international economic decision making.

A Three-Pronged Approach

Even with sufficient authority and resources, the United States must have a vision of how it wants to use those tools.

Just after World War II, the United States advocated market opening because, as the world's largest economy, it had much to gain and politically could afford to. In the 21st century, the United States should still pursue that goal because, as the world's largest exporter and importer, it economically cannot afford not to.

In recent years, the United States has pursued market liberalization simultaneously at the multilateral, regional, and bilateral levels. This three-pronged approach has provided the United States with maximum options and leverage. It has served our trade negotiators well and should continue to be the framework for U.S. market opening efforts. But the U.S. approach to trade negotiations has often been more tactical than strategic, with an *ad hoc* quality that failed to best serve our interests. In the future, the three levels of U.S. effort at market liberalization should be better calibrated to reinforce one another.

Multilateral negotiations are necessarily the foundation of any initiative to further open global markets. Only within the context of a multi-issue deliberation is it possible to obtain negotiating trade-offs—for example, swapping concessions on maritime services for concessions on agriculture. Most recently, because of negotiating fatigue, the United States has let the Europeans take the lead in efforts to launch a new multilateral round. History suggests this is a prescription for a minimalist negotiation. If there is to be a meaningful new round of negotiations, the United States will have to shape it.

A similar challenge faces the United States in APEC and FTAA. APEC was instrumental in completion of the Information Technology Agreement, which eliminated significant tariffs on a range of electronic goods and demonstrated the catalytic role that regional efforts can play in global liberalization. Washington should selectively use regional liberalization to leverage multilateral action. Regional trade endeavors do, however, run the risk of turning inward, dividing the world into hostile trading blocs. As the world's sole economic super power, the United States has the greatest interest in ensuring that regional agreements are outward-looking, so that markets in all parts of the world remain open to U.S. goods and services.

Finally, the United States has long borne the brunt of efforts to crack open individual markets—from the semi-conductor market in Japan to the intellectual property market in China to the banana market in Europe. It has been a controversial undertaking, but trade is now freer because of these efforts and protectionist pressures in the United States are less. Bilateral trade initiatives have helped build domestic support for trade by highlighting the immediate benefits of market opening. Thus, while bilateral liberalization will generally be less beneficial than broad-scale multilateral or regional trade opening, it remains an important tool for market integration.

Strength Through Cooperation

Leadership often can most effectively be exercised through recognition of the limits of one's own power and coordination with other like-minded nations in the pursuit of mutually-beneficial ends. Clearly, the global economic challenges of the 21st century will require the concerted efforts of the world's major economic powers.

The oil crises of the 1970s gave birth to the annual G-7 Summit of the world's major industrial nations. Now, a generation later, it is time to update and streamline that process. The G-7 has long operated as a fire-fighting brigade, responding to crises rather than anticipating them. To play a more decisive, proactive role, the G-7 should be smaller—a G-3 limited to Japanese, American, and a single European membership. The G-3 could be the vehicle for mobilizing new liquidity in the face of future financial crises, for pushing through reforms of the international financial institutions, and for exerting greater peer pressure in the informal coordination of monetary and fiscal policies.

Asia provides another arena for greater international cooperation, since the United States increasingly needs the cooperation of Europe and Japan to cope with the ongoing financial problems and to ensure that Asian markets are more open to trade, investment, and international competition. The combined market power of the G-3 could be a powerful tool for leveraging Asian market liberalization. There is precedent for such an approach; Washington and Brussels have jointly insisted on high standards for China joining the WTO, and the G-3 have joined each other in several WTO cases.

Washington can best pursue American interests in Asia by building on this cooperation. For example, Washington, Tokyo, and Brussels could agree to abstain from WTO-illegal protectionist measures in future economic crises to avoid outcomes that serve no country's interest. In the long run, the United States, Japan, and the European Union will want to work together even more closely in multilateral forums such as the WTO, the IMF, and the Bank for International Settlements to shape the rules of finance and trade for the 21st century.

Do No Harm

One hallmark of leadership is to know when not to do the wrong things. In this regard, U.S. policies concerning economic sanctions and unilateral trade actions are instructive.

In recent years, the United States has repeatedly sanctioned trade and foreign investment. The most recent examples are the Helms-Burton law that punishes European, Asian, and Latin American firms for doing business with Cuba and the Iran/Libya Sanctions Act that penalizes firms that do business with these rogue states.

The high-minded goals of such sanctions are seldom in dispute. But history judges results, not intentions, and the track record of sanctions suggests that they usually do not work. Only about one-third of the economic sanctions imposed during this century achieved their intended goals.[16]

This meager success rate has come at a cost. Trade sanctions reduce U.S. exports, and exports lost today often mean fewer exports tomorrow, because firms will not be called on to supply replacement parts or related technologies. In addition, sanctions indicate that American firms are "unreliable suppliers," often leading foreign firms to design-out U.S. intermediate goods and technologies or to decide against buying U.S.-made final products.

These intended and unintended consequences exact a heavy toll. In 1995 alone, U.S. economic sanctions may have reduced U.S. exports to 26 target nations by as much as $19 billion, reducing export employment by 200,000 and American families' incomes by nearly $1 billion in the higher wages those more productive jobs would pay.[17]

Unilateralism in U.S. trade policy can also be problematic. Unilateralism is sometimes necessary as a negotiating tactic, but strategically it often backfires. Unilateral action can correct trade abuses. In the mid-1980s, foreign firms had a mere 8 percent of the lucrative Japanese semi-conductor market. The threat of American trade sanctions forced Tokyo to sign the U.S.-Japan Semiconductor Agreement, setting targets for the opening of the Japanese market. By the end of 1996, the foreign share of that market had risen to 30 percent. Moreover, at times unilateral action, or the threat of such action, is the only way to get a trading partner to take U.S. concerns seriously. In the early 1990s, for example, it took impending sanctions to get the Chinese finally to protect intellectual property rights.

Yet the cost of unilateralist trade policy is high. Like an antibiotic that is used indiscriminately, the overuse of unilateral trade actions breeds resistance. This has been particularly apparent in U.S. trade relations with Japan. By the mid-1990s, having been stung repeatedly by U.S. trade actions, the Japanese Ministry of International Trade and Industry refused to even discuss trade problems while under the cloud of unilateral U.S. trade sanctions. This attitude stalemated American efforts to resolve a number of problems, because Washington did not have a sufficiently strong case to haul Tokyo before the WTO. Moreover, Japan's perception of American unilateralism as high-handed has provided dry tinder for Japanese nationalists, complicating U.S. foreign policy.

Even the most well-intentioned unilateral actions can have unintended consequences. For example, the real beneficiaries of trade restrictions are often foreign producers, who are able to charge higher prices for relatively scarce goods and reap the profits. In the mid-1980's, for example, at the behest of the American auto industry, the Reagan Administration forced Japan to "voluntarily" restrain car exports to the United States. This limited Japanese import penetration of the U.S. market, but enabled Japanese auto makers to boost prices and pocket an additional $5 billion a year in profits at the expense of American consumers.[18]

Finally, with the creation of the WTO and new global disciplines on trade, the United States has agreed to submit to international dispute settlement many issues that were once the subject of unilateral action. Washington can choose to ignore those commitments, but would then have to pay compensation to the affected countries. More important, such action would rapidly undermine the legal framework for dispute settlement that the United States worked so long to create.

For these reasons, unilateral U.S. trade actions may be severely constrained in the future, limited to those narrow areas, such as competition policy, where the WTO does not yet have competence, or applied against countries, such as China, that are not yet members of the WTO.

Mobilizing Public Support

U.S. global economic leadership will not be possible without the support of the American public. That support will not be forthcoming without the concerted effort of elected officials and the business community to mobilize and mold public opinion. But the public's depth of suspicion about the globalization of the economy also demands that opinion leaders listen as well as preach. As demonstrated by Congressional rejection of fast track trade negotiating authority in 1998 and the prolonged struggle to secure additional funding for the IMF, such an effort will be a difficult, uphill task. But it is not an impossible one.

In the past, the American people have rallied to their international responsibilities when they understood the stakes involved and had a clear vision of the actions required. In the late 1940s, there was widespread fear that, despite the searing experience of the Depression and World War II, the public would once again turn its back on the world, as it had done after the first World War, when the Senate rejected U.S. membership in the newly formed League of Nations. But through a concerted effort by the Truman Administration, the CEOs of major American corporations, academics, and other opinion leaders, Congress approved the Marshall Plan, an unprecedented transfer of U.S. resources abroad, to vitalize European recovery.

The economic challenge faced by the United States today is not as severe as that posed by postwar reconstruction, nor the required financial resources as great. Yet the United States has as much, if not more, to gain from a revival of emerging markets and from the further liberalization of trade and investment around the world. The necessary precursor for American leadership in the face of these challenges is once again the support of the American public.

Neither Isolationist nor Protectionist

Contrary to popular characterizations, the American public is neither isolationist nor protectionist. Most people, most of the time, give the international economy little or no thought. Trade consistently ranks at the bottom of lists of public concerns, trailing education, drugs, crime, immigration, and a range of other issues.

When the public does periodically concern itself with trade, people are profoundly ambivalent. More than half the public (54 percent) believe that globalization is mostly good for the United States, according to a 1999 survey by the Chicago Council on Foreign Relations. These findings are borne out by surveys conducted by private pollsters, who have found that a majority of respondents support free trade agreements with other countries. Nevertheless, a plurality would ban or restrict imports of foreign-made goods to protect certain American jobs.[19]

Appeals to Hearts and Minds

This ambivalence suggests that the American public has yet to reach a firm conclusion about whether the globalization of the U.S. economy is beneficial. Overcoming that ambivalence will require a public dialogue that places globalization in the broad context of U.S. political and economic interests, confronts public misperceptions about U.S. engagement in the world economy, ensures that public policy decisions affecting U.S. global interests are made in a democratic fashion, and addresses people's real concerns about the impact of the international economy on their day-to-day lives.

The globalization of the economy cannot be dealt with in isolation. It is part of a broader public discussion of a range of global issues such as climate change, terrorism, drug trafficking, and AIDS that are of growing citizen concern. Only in this context can the public see the inter-connections between (for instance) foreign investment in energy efficient technologies and efforts to slow global warming or between increasing U.S. imports from Africa and reviving the economies of that AIDS-decimated continent.

To rally Americans around new U.S. international economic leadership, the first challenge is to make policies appeal to the public's hearts as well as to their minds. If American workers are to bear some of the costs of free trade and American taxpayers are to help pay for bail outs when emerging markets turn sour, they want to do so in a good cause. For many years, the Cold War provided moral justification for an open U.S. market, global trade liberalization, and support for the international financial institutions. Today, to inspire Americans with a new sense of purpose, advocacy of further reduction of trade barriers or financial bailouts must be linked to the preservation of peace, the global reduction of poverty, and the creation of more tolerant, inclusive, and democratic political systems around the world.

Overcome Misperceptions

The second challenge in building public support for continued U.S. global engagement is to overcome public misperceptions about trade and the economy. Americans think the number of jobless people in the United States is much higher than it actually is, and most believe that there are fewer jobs than there were five years ago. It is little wonder voters worry about the impact of imports on employment. Few workers know of their foreign customers or what portion of their paychecks come from exports. Consumers are often blithely ignorant of the ubiquity of imports in their everyday lives or the benefits they confer in wider choice and lower prices. Taxpayers also routinely overestimate the magnitude of U.S. foreign aid, assuming it makes up 15-20 percent of the federal budget, rather than less than one percent.

Resolving these contradictions is a task for public education. It will require engaging plant managers and workers and state and local officials in a community dialogue about the benefits, opportunities, and costs posed by the new global economy. As an example of such an endeavor, the state of Washington brings together representatives from the port authority, the business community, and the schools for summer seminars on trade. Similar efforts are needed throughout the country.[20]

Correct the Democratic Deficit

The third challenge is to reduce the democratic deficit that now exists in making trade policy. Many American voters, much of the Congress, organized labor, environmental and human rights organizations, and significant segments of the business community no longer feel that U.S. trade policy reflects their interests and concerns. Re-engaging these key constituencies will require wider input to trade policy formulation in the executive branch, more Congressional involvement in defining trade policy goals and the conduct of trade negotiations, and changes in the way Congress considers trade agreements.

Such a process will not be neat. The United States cannot have 535 members of Congress negotiating trade agreements. But the refusal of Congress to approve fast track demonstrates that the White House no longer can expect merely to consult with Congress about ongoing trade negotiations to gain its approval. Some middle ground is needed.

Some of those brought into the decision-making process may attempt to sabotage it. But they already have demonstrated their ability to throw sand in the works if their concerns are not addressed. The U.S. Trade Representative's office has had private advisory groups since the early 1970s, so citizen involvement in trade policy making is not new. But it does need to be improved. Only by creating a democratic process through which various stakeholders can "buy into" trade initiatives can the United States hope to have broad support for them.

This need for democratization applies to the broader policy machinery of the world economy. The IMF, the World Bank, and the WTO have long been criticized for their secretiveness. Nothing incites fear and opposition more than decisions made behind closed doors without involving those whose lives will be most affected by them. Former WTO Director General Renato Ruggiero has called non-governmental organizations (NGOs), such as labor unions and environmental groups, "a bridge, an essential link" between the WTO and the public. And President Clinton urged greater ties with NGOs in his speech at the 50th anniversary of the founding of the General Agreement on Tariffs and Trade in May 1998.

Acknowledge People's Problems

Finally, public concern about globalization reflects the recent bitter experience of a decade and a half of wage stagnation, growing income disparity, and job displacement that the public attributes to competition from abroad. High-sounding rhetoric about the glories of the international economy will do little to change those attitudes. Ultimately the perceptions and experiences that gave rise to those views will have to change.

To that end, trade must be seen as equitable, both domestically and internationally. This is a significant political problem as long as the United States is running massive trade deficits. On occasion, it will be necessary for the United States to take a tough stance on trade issues, if only to demonstrate to voters that trade negotiators are not afraid to stand up for America's interests. The economic merit of such a “get tough” approach is questionable. But the political value can be significant. For example, some trade experts criticized the hard-nosed approach to Japan taken by the Clinton Administration from 1993 to 1995. But it was very popular with voters. By “sticking up for America” in this highly visible way, the Clinton Administration bought itself maneuvering room to pursue highly controversial trade liberalization in the Uruguay Round and NAFTA.

In relation to its output, the United States takes twice as many imports from low-wage nations as does the European Union and 60 percent more than Japan. New regional or multilateral trade agreements must ensure that other industrial nations more equally share the burdens of adjustment to greater world trade as well as enjoy the benefits of expanding exports.

Similarly, the adjustment costs created by a greater opening of the U.S. economy must be more equitably shared domestically. Over the last two decades, the pace of globalization accelerated at the same time that workers’ wages stagnated and the gap between the incomes of the very well off and average workers grew larger than at any time since World War II.

More recently, wages in the United States have again begun to rise, in part due to the dramatic increase in U.S. exports and the higher pay earned by workers in export-oriented industries. Moreover, recent studies suggest that trade and immigration account for no more than 20 percent of the increased wage inequality, which has resulted principally from technological change.[21] Nevertheless, the perception of a stronger and more pervasive causal relationship lingers in the public’s mind. If wages again begin to stagnate and income inequality continues to grow, it will be increasingly difficult to maintain public support for further globalization of the economy.

Workers harbor similar anxiety about the security and stability of their jobs in a global economy. There is nothing new about fluidity in the labor market. The concept of a “normal” work life, in which a worker takes a job upon graduation from school and retires from that same job 40 years later, is a myth. The average American worker now stays at a given job only about seven years, much the same as a decade ago, and will change jobs six to eight times in his or her lifetime. In a global economy, this flexibility is one of the strengths of the U.S. economy, enabling constant adaptation to market changes. But the personal costs of flexibility are high. If the American public is to view such change as an advantage, not a threat, then workers must be better prepared for the constant flux demanded by international competition.

Prepare Workers for the Future

Throughout economic history, changes beneficial to society as a whole have brought hardship to some. As the old economy dies and the new one is born, those who bear the costs will naturally seek to impede such change. This can be prevented only if they can be convinced that the costs will be shared and that they and their children will, over time, have the opportunity to gain the skills necessary to succeed in the new global economy.

The United States has long failed woefully in this task. In 1997, the government spent only about $900 per displaced worker to provide trade-related adjustment assistance. First-class training to provide the skills necessary to compete in the global economy would have cost twenty times that. Finally, in August 1998, the Congress enacted new legislation consolidating dozens of retraining programs and providing “individual training accounts” so that workers can choose the type of training they need. Such an effort is a step in the right direction. But both the government and the private sector will have to improve retraining efforts to adequately prepare and adapt workers for an increasingly competitive world. Experience suggests that neither public nor private retraining works well, and that the benefits of retooling the work force are frustratingly elusive.[22]

Retraining, however, merely patches up the casualties of change. A much more important task is adequately preparing workers initially for the demands of changing technologies and markets through a much-improved educational system and life-long learning. Educational reform is a perennial issue in American society, but the globalization of the economy gives it added salience. The skills and competence of American students and the workers they become will increasingly be benchmarked against their Japanese and European counterparts. And educational success or failure will have bottom-line consequences for our economy.

In the end, there can be no substitute for Presidential leadership in building public support for global economic engagement. It is the President’s ability to command the “bully pulpit” and to conduct the “fireside chat” that can shape public attitudes about major policy issues. In his first term, it was President Clinton’s personal commitment to the North American Free Trade Agreement that ultimately led to its successful completion and Congressional passage. Conversely, the President’s failure to expend his political capital in 1997 is widely blamed for Congress’ failure to grant the Administration fast track trade negotiating authority. Given the growing importance of the international economy to the livelihood of the average citizen, it is the President's responsibility to help the American people come to terms with the changing challenges and opportunities of globalization. It will require consistent straight talk in a variety of forums. No one else has the stature to conduct that dialogue.

Conclusion

The challenges facing the United States in the global economy in the 21st century are formidable. The global financial system has grown in size and complexity far beyond that ever anticipated by its architects at Bretton Woods. The volume of capital that moves about the world on a daily basis, its varied sources, and the sophisticated financial tools used to manipulate it far exceed the ability of national regulators to ensure its prudential use. The global financial crisis that rapidly spread from the 1997 Thai banking crisis underscores how vulnerable the international financial system has become. The IMF and World Bank do not have the resources and may lack the mandate to cope with this rapidly evolving situation.

The growing contribution of the global economy to America's well being highlights our stake in an open world economy with relatively unimpeded trade and investment. But the struggle for market liberalization will increasingly be uphill, as more and more of the barriers involve services and regulated industries long resistant to foreign competition.

Ensuring open markets and financial stability in the next century will require renewed American leadership, with the authority and resources needed to carry it out. Most important, such leadership will require the strong support of the American public. The task is formidable. But with the future well being of America in the balance, the United States has little choice but to accept the responsibility for continued leadership of the global economy.

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